BUSINESS BUDGETING
·TECHNICAL NOTES MAGAZINE·

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ACROSS THE EDITORS DESK

With this issue we make our bow in an entirely new format, new name, new emblem, and new hopes for a successful year of publication. Like the organization itself, this publication is experiencing growing pains. Although we haven't yet come of age, the new layout you are now looking at was designed as a preparatory step as The National Society For Business Budgeting approaches stature as a leading national business organization.

Thanks to the national board of directors--progressive fellows!--the change in name from "Technical Notes" to "Business Budgeting" was approved in time for this issue. The new format won't improve the quality of the articles, but it is an intermediate step to a genuine sure-nuff magazine when we are ready. . . . which may not be far off, if N.S.B.B. continues its rapid growth.

Your new editors will endeavor to guide Business Budgeting along lofty lines, but we hasten to emphasize our total and complete dependence upon you chapter members for articles of interest. Each chapter is expected to contribute each year sufficient material for one complete issue, through your chapter magazine chairman. So loosen up your vocabulary . . . . see your name in print . . . . join the ranks of journalism and put on paper that article you've been intending to write for a long time.

In addition to articles by N.S.B.B. members, your editors will from time to time bring you material written by nationally-known experts on budgeting, forecasting and various phases of business planning. We'd like also to have a "Letters to the Editor" column, if we had any letters to the editor. Maybe we will--maybe you'll write us . . . . to discuss some particular budgeting problem, take issue with an article, or just to get something off your chest.

ABOUT OUR AUTHORS

Due principally to geographical reasons, our current issue of Business Budgeting features material submitted by members of the Cincinnati Chapter, N.S.B.B.

Mel Aichholz, Budget Director of Bavarian Brewing Company, is a ham--pardon us, Ham. In English, that's amateur radio operator. Mel even has an outfit in his auto, and frequently talks to fellow hams a thousand miles away while driving to his office. We don't know how, but Mel finds time to teach a radio code class, take part in Scout activities, Community work, Church work and business organization activities. An avid budget man, Mel has a remarkable library of books and articles on the subject. If you haven't met him yet, you will; he has a habit of dropping in on N.S.B.B. chapter meetings in far-away cities.

Clyde Thielen was a "natural" for first secretary of the Cincinnati N.S.B.B. Chapter--he had a typewriter, a wife who can type, and the N.A.C.A. mailing list. Actually, Clyde is the serious, hard-working type that makes a success of everything he does. About a year ago he took the big step--he resigned his position with a large corporation and with two other stout fellows opened a small manufacturing business. There's one thing we don't think Clyde and company will ever be--a Dun & Bradstreet business failure statistic.

Ed Beard is Cincinnati Chapter's expert on antique guns. His collection is one of the best in the area and with practically no coaxing at all Ed will talk old-guns anywhere, anytime. He'll talk budgeting too, and after listening to him for just a short time you definitely get the impression that Ed is mighty proud to be a member of the great Allis-Chalmers budget team.

DIRECT COSTING – A NEW TOOL OF MANAGEMENT

By: Melvin C. Aichholz

Budget Director, Bavarian Brewing Co., Newport, Ky.

All over the country, members of The National Society for Business Budgeting are being asked to participate in NACA forums. In Cincinnati, three chapter members took leading roles in a forum on Direct Costing. Here in summary are some of the points which were developed – a stirring challenge to Budget men to open a new door in their approach to Planning Profits.

If accountants were to ask themselves, "Is there any area in which the traditional and time-honored premises of accounting are challenged?", they might very probably come up with the answer, "yes, there is such a challenge in the theory of direct costing." For such is the message of the theorists and practitioners who for a good many years now have been proposing what they have been wont to call a new theory of accounting.

DEVELOPMENT OF DIRECT COSTING

Business men have long realized that volume has an important influence on costs and profits. Direct costing is a plan for providing management with more information about cost-volume-profit relationships and for presenting this information in a form more readily understandable by management at all levels. This is accomplished by integrating and incorporating into the accounts a group of related techniques which include the flexible budget, breakeven chart, and marginal income analysis. While most of the same facts can be obtained by statistical analyses prepared to supplement accounting reports in conventional form, direct costing yields the desired results without additional analysis.

The experience which industrial accountants have had with direct costing to date does not constitute a sufficiently broad base from which to draw definite conclusions as to general usefulness of direct costing. For this reason, the advantages and disadvantages advanced in connection with the method are presented for your study and consideration:

ADVANTAGES OF DIRECT COSTING

1. Significance of Volume in Profit Planning

Most managerial decisions are affected, in part at least, by the changes in costs and sales income which accompanies changes in volume. For example, volume needs to be considered in decisions such as pricing products, budgeting advertising expenditures, adding or dropping products, and in making capital expenditures for new machinery. Volume is accordingly one of the key factors which must be considered in profit planning Moreover decisions of the type here under consideration are made frequently and the need for analysis of cost-volume-profit relationships is recurring.

A study shows that users of direct costing view the ready availability of cost data in a form appropriate for profit planning to be a major benefit from direct costing. Even when the fixed and variable components of costs are known, the regular accounting statements must be supplemented by additional statistics to provide management with needed information about cost-volume-profit relationships. This necessitates additional clerical time for preparing the separate figures and additional managerial time spent in working with two sets of data. Experience of some companies also shows that executives who are unfamiliar with accounting techniques may find it difficult to reconcile supplementary statistical material such as break-even charts with operating figures shown by the absorption cost type of income statement.

2. Direct Costing for Profit Measurement

Advocates of direct costing maintain that more significant net profit figures result when all fixed costs are treated as period costs. The reason for this opinion is that the effects which changes in sales volume have on profits are not obscured by concurrent changes in production volume when fixed costs are not absorbed into inventory.

When fixed costs are treated as period costs, net profit varies directly with sales volume provided profit influencing factors other than volume (e.g., selling prices, sales mix, and manufacturing costs) remain unchanged. On the other hand, when fixed costs are absorbed into inventory, profits are affected by changes in inventory as well as by sales volume. While the amount of the change in the fixed component of inventories can be determined when fixed and variable portions of the manufacturing costs are known, it is then necessary to prepare an analysis in order to explain the causes of the change in profits. In evaluating the effect which changes in sales volume have on profits when using absorption costing, management must consider the two influences, production volume and sales volume, which may work together or not, calling for accounting knowledge which few executives possess. A field study provided a substantial amount of evidence to the effect that management is often confused, or at best fails to understand fully, when changes in the fixed cost component of inventory obscure relationships between sales volume and profits which could be readily evident under direct costing.

3. Management's Need for Direct Costing

An understanding of the relationships between costs, volume, and profits enables management to choose its objectives on a more realistic basis and to make decisions with greater assurance that objectives will be reached. Consequently, the development of factual information about the behavior of costs and profits under conditions of changing volume and effective presentation of this information is an area in which the industrial accountant has an opportunity to make an important contribution.

However, this information is not provided by the periodic manufacturing cost and income statements which are generally used because no distinction therein is made between fixed costs and costs which vary with volume. As a result, supplementary statistical compilations and analyses have been necessary to provide management with the information needed in reaching decisions on the many questions where the variations in cost which result from changes in volume of production and sales should be considered. Among these supplementary techniques are the flexible budget and cost-volume-profit analyses to produce the data shown on break-even charts and in marginal cost and income analyses.

In discussion, direct costing is usually presented as an alternative to "absorption costing." The latter term is used to cover any of the various methods whereby fixed manufacturing costs are applied to production and

included in inventories. The significant characteristic of absorption costing is that fixed and variable production costs, are merged in charges to the same accounts. In contrast, direct costing maintains the separate identity of fixed and variable costs in the accounts.

4. The Direct Cost Income Statement

One of the principal objectives of direct costing is an income statement in which costs are grouped according to their variability with volume. This order of presentation emphasizes the company's profit structure and provides the facts for an understanding of relationships between cost and volume. Statements of the individual companies will differ in details, but all follow essentially the same general pattern.

In commenting upon the order in which costs are deducted from sales income, representatives from several companies interviewed stressed the importance of deducting fixed costs only after all variable costs have been deducted. In this way, the direct costs represent the out-of-pocket cash expenditure needed to make and sell the goods sold during the period.

5. The Marginal Approach to Costs for Planning

In choosing among alternatives, differences in cost and profits are more significant than absorption cost totals and managerial thinking often follows the marginal approach even when the accountant does not do so. Obviously, the difference in cost between two alternatives involving different volumes is measured by the difference in total variable cost and is unaffected by fixed costs. Comparison of alternatives for relative profitability can likewise be made by comparing marginal income figures.

Marginal income measures the profit value of volume increments. For this reason, direct costing is particularly helpful in decisions which deal with individual segments of the business because it provides the needed marginal income figures in accounting statements received regularly by management

Product Selection and Emphasis

In a multiproduct company, management wants to know the relative profitability of the various products as a guide in selecting the items to be made and deciding how the emphasis is to be distributed in selling. Where sales are made to different classes of customers and in territories some of which are more profitable than others, management has a similar problem in finding the most advantageous sales mix for each of these classes of segments. With the marginal approach, segments can be evaluated individually according to the contribution each makes to over-all income.

Usefulness of direct costing for product selection and emphasis stems from the ease with which cost and profit differences for different volumes of individual products can be ascertained. The additional cost of additional production (or the saving from decreased production) is simply the product of unit variable cost times the number of units in question. By deducting this cost figure from the income received from the sales increment, the additional to (or decrease in) overall profit results. Since these decisions often affect only limited segments of the company's operations, they can usually be made on the assumption that established fixed costs will continue without change.

6. The Flexible Budget Related to Direct Costing

In order to assist management in controlling costs and in comparing costs and profits when deciding between alternatives, flexible budgets, break-even charts, and marginal income analyses were developed by many companies to supplement the regular accounting procedures for costing production. These techniques for analyzing and interpreting the influence of volume on costs and profits were all based upon a classification of costs according to variability with volume. Some accountants therefore decided to incorporate this classification of relationships in the regular accounting statements. A step in this direction had already been taken where flexible budgets were in use for cost control purposes because fixed and variable costs were accumulated separately and shown separately in departmental cost statements. Under these circumstances the same basic classification of costs by variability with volume was extended to the processes of costing production and the results shown in the income statement as well as in departmental cost control reports. In some, but not all companies, the process was also extended to include costing of inventories at variable manufacturing cost.

7. Advantages Advanced for Costing Inventory at Direct Cost

Advocates of direct costing advance the following as advantages to be gained by costing inventory at direct cost.

A. The use of direct cost for inventory simplifies the process of determining product unit costs because it avoids the problems associated with selecting a volume base for allocating fixed costs. At the same time direct unit costs are more reliable because they can be factually measured. In contrast, the process of allocating fixed costs to product units requires a volume base for allocation which must be selected by judgment and estimate.

B. Direct cost is more useful in decisions which management makes with respect to inventories because variable cost is closely equivalent to the amount of cash that will have to be spent to add a given number of units to inventory. Inventory policy decisions often deal with the question of whether to convert cash into inventory or vice versa. However, under absorption costing the cost of the inventory is not so directly related to the amount of cash which must be spent to manufacture the goods.

DISADVANTAGES OF DIRECT COSTING

1. Fixed Costs must be separated from the Variable Costs

In many companies most of the needed information about cost variability with volume is already available in the standards and flexible budgets which have been developed for cost control purposes. However, costs expressed as variable for one purpose are not always fully variable for other purposes.

The separation of fixed and variable costs cannot be completely accurate, for there is always a borderline area and costs which fall within this area are not clearly fixed or variable. Experience of companies using direct costing and also of companies using flexible budgets without direct costing shows that this area can be reduced to a point where uncertainty about the proper classification of costs does not significantly affect reliability of statements prepared for management.

2. Direct Costing as a Guide to Pricing

One of the criticisms most frequently leveled against direct costing is that it may lead to disregard for the need to recover fixed costs in pricing. Companies interviewed were unanimous in the opinion that this had not occurred in their experience.

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BUDGETING & FORECASTING PROBLEMS OF A NEW BUSINESS

By: Clyde H. Thielen

Secretary, The Melben Products Co., Cincinnati

If the Company is small are the budgeting problems small? Does a new business have much need for Budgeting know how? If you've never had experience with a new small business just getting underway, you'll probably be surprised at the answers. Here is a down-to-earth account of small business financial problems written by a down-to-earth small businessman.

This article will endeavor to show the preparation and forecasting problems of a newly formed corporation who manufactures sheet metal to order.

A partnership as of December, 1953 with three partners and three employees, we formed a closed corporation as of January 1, 1954. During January the company purchased press brake for approximately $10,000. To finance this piece of machinery, it was necessary to prepare a budget for the bank including a P & L statement and balance sheet as of December 31, 1954.

From information obtained from the other members of the company as to the estimated percent of profit before taxes for this type business and the percent of raw materials to sales I was able to prepare a budget.

The sales volume was then determined to be $150,000 with a raw material cost of $60,000. At this point it was immediately realized that to produce this volume of sales would require a work force of approximately eight men with each of the officers devoting approximately 50% of his time to direct production. This estimate proved to be correct as far as production was concerned, however, an additional two men were required for painting. After the direct labor was determined items related thereto were budgeted such as:

Unemployment tax
Workmens compensation
Employee Federal OAB Tax

However, as I later found out the State requires a deposit based on an eight months payroll be paid to the workmens compensation fund upon filing for coverage. In our case this amounted to approximately $620 and was not covered by the budget.

The next items budgeted were those of a fixed nature such as Rent, Insurance, Depreciation on M & E, Depreciation on Building Improvements, and personal property taxes. The last three items to be budgeted were estimates pure and simple, -- Heat, Light, & Power; Shop Supplies, & Misc., Manufacturing expenses. The actual expense for the latter two items compare very favorable with the budget. However, the electric light and power far exceeded the budget due to the installation of an electric degreaser used to prepare the metal for painting. All of the items budgeted so far represent the cost of sales which is equal to 69.1% of Sales.

The items which make up the selling and General Expense classification were not so difficult to budget and are composed of the following: Salaries, Postage, Stationery & Printing, Advertising, Delivery Expense, Telephone, Depreciation on F & F, Unemployment Tax, Workmen's Compensation, Federal OAB Taxes, Traveling Expense & Car Allowance, Interest Expense, and Misc. General. This group of expenses represents 13.7% of Sales.

To determine the burden rate to be applied to individual jobs the total cost of operations less raw material and direct labor was divided by the direct labor hours. This came to $1.05 per hour. The direct labor divided by direct labor hours produced a labor rate of $2.08 per hour or a total cost exclusive of raw materials of $3.13 per hour. With the addition of the two extra men we find that a rate of $3.00 per direct labor hour is more nearly correct.

The balance sheet items were relatively easy to budget as it was determined to carry only a small raw material inventory ($2000) and that no additional equipment would be purchased. This however, proved to be a gross misstatement. During the first four months of 1954 an additional $6500 worth of machinery had been purchased. Also inventories are slightly in excess of $4500.

As of May 31, the approximate variance from budget will be as follows:

Sales - over budget	4%
Raw Materials - under budget	6%
Mfg. Expenses over budget	21%
Selling & General under budget	25%
Net Profit, Variance	0%

Each Saturday morning the three officers meet to discuss the financial condition of the business, anticipated sales, and what is to be produced during the coming week. At the conclusion of this meeting the shop foreman and the layout man are called in and the production for the past week is reviewed. Also the new production schedule is discussed. The layout man determines when the jobs will be ready for production and what dies are required. The production foreman indicates where he expects bottlenecks and expresses his opinions as to what changes should be made.

Now to touch on the major problems confronting small business, and I am quoting directly from the April Issue of Nation's Business.

"1. Need for better skills
2. Need for money
3. Need for tax relief

"Small Business demands even more training than big business--but of a different sort. Required here are general rather than specific skills. The small business man must be versatile. He may for example have to prepare a sales campaign, hire a foreman, repair a machine, pack a rush order, assist the bookkeeper with an annual audit, sooth a dissatisfied customer, negotiate with the union or bank, -- all tasks which specialized personnel handles for big business."

However, it must be remembered that the small business man is no genius and he must obtain his information from somewhere. The alert operator seeks information regarding his problems from the manuals published by management, accounting, purchasing groups, etc. Also he has at his disposal a great many pamphlets published by the Federal Government on most any subject.

Point Number two. The need for money is more difficult to solve. The banks and finance companies have liberalized their credit to small and new companies on a short term basis but long term financing still remains a problem. To overcome this the Federal Government has established the Small Business Administration. This organization is empowered to make loans direct and also assist in obtaining loans from other lending agencies. However, by and large the new or small business must depend on

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BUDGETING PROBLEMS OF A NEW BUSINESS

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whatever profits it can make after taxes to meet its money problems.

Item three. Need for tax relief has been somewhat alleviated by the rescinding of the excess profit tax. At present, there is a bill in the House (The Mills Plan) to accelerate tax payments. Also the administration has urged that in the Autumn of 1955 a start be made towards a pay as you go tax procedure. This would mean during the first part of 1956 a double tax load would exist. Small and new organizations without adequate reserves would be forced to borrow during this period. At present, there is no tax relief in sight.

In addition to the afore-mentioned three items one very important point stands out in my mind--growing pains, or over-expansion. This particular item has given our company more headaches than any other. With the development of each new customer or product we found ourselves investing in new tools, dies, and machinery. As of April 30, we had invested the major portion of our earnings in fixed assets, thus sharply curtaining our working capital. This pitfall can reduce a going business to bankruptcy in a very short space of time.

DIRECT COSTING - A NEW TOOL OF MANAGEMENT

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In several instances, comments were made to the effect that better pricing had followed adoption of direct costing because executives were better able to understand the relationship between costs, volume, prices, and profits.

3. Direct Costing used in External Financial Reports

While direct cost seems to be within the range of inventory cost concepts currently used in industrial practice, statements of professional opinion neither approve nor disapprove direct costing in specific terms. Widespread interest in direct costing has arisen so recently that additional time and experience will probably be required before definite conclusions can be drawn as to its general acceptability in external financial reports.

The fact that direct costing has, until very recently, been known and used by only a few companies leads to the conclusion that it cannot be judged by asking whether or not it is a generally accepted accounting procedure. The very fact that a procedure is new causes it to differ to some extent from those accounting procedures now generally accepted. If it proves to be an innovation which serves users of accounting information better than existing procedures, it is to be expected that direct costing will, with time, become generally accepted. In the meantime, it seems that the test to be applied is whether or not it does, in a given company, enable the accountant to provide better information about costs and profits to those who use these figures.

Some companies feel that most of the above disadvantages can be overcome or are less important than the advantages which they obtain from direct costing. Income tax problems which arise at the time of changing from absorption costing to direct costing seem to be the most serious obstacle to wider use of direct costing. By confining the application of direct costing to internal reports, income tax questions can, of course, be avoided and a number of companies have followed this course.

SELLING THE BUDGET TO LINE SUPERVISION

By: Edward L. Beard
Norwood Works – Allis-Chalmers Manufacturing Company

Sound familiar? This has always been and will always be the prime challenge to the Budget Director. Here is how the budget folks at the Norwood Ohio plant have sold the nationally famous Allis-Chalmers budget system to their line supervision so successfully.

We have often heard the expression "How to Sell the Budget to Management", but how often do we even think of the expression "Selling the Budget to the Foreman or other Production Line Supervision"? Almost all progressive business establishments are budget conscious and management is fully cognizant of the value of proper budgetary controls. After all, no business can function properly without accounting and budgeting is accounting for the forecasted profit and loss factors. So our problem is to sell the budget to line supervision.

No sound business can operate satisfactorily unless two very important assets exist. While these are not listed on the balance sheet specifically, they do have a direct bearing on the difference between a profit and a loss. I refer to customer goodwill and employee goodwill. While budgets may not have much bearing on customer goodwill, they will have much to do with employee goodwill especially in the line supervision brackets. Some budgets are prepared by management with no representation from the very same personnel who will ultimately control expenses with respect to the manufacturing budget. Such a procedure should be reversed. Prepare your manufacturing budget with representatives from production line supervision and then take it to management. Don't prepare an impressive array of figures and statistics in the front office and then confront your foreman with the prohibitive terminology that "you can't spend this", "you can't do this", and "you can't do that". With such an approach you immediately create friction and an antagonistic attitude. If you prepare your budget with the suggestions and experiences of your foreman along with front office statistics, then you have a saleable item and he will do his utmost to cooperate.

A proper and controlled manufacturing budget is a tool and certainly must be considered as such by your supervision as well as management. Assuming that the budget is properly prepared we must now present it on a report form. An acceptable method is to tabulate monthly manufacturing expenses broken down to a chart of accounts for each production center. The budget allowances are likewise shown for comparison and percentages of actual to budget indicated. As an added feature the "year to date" amounts can be shown in a similar manner. Such a report is easy to digest and when presented to your foremen monthly will even create a spirit of rivalry in keeping expenses within allowances.

With proper educational programs you can teach your foreman to be his own budget analyst while the accounting department can be the "watchdog". Each month the budget supervisor should analyze any items exceeding the breaking point and report his findings to the foreman as well as management. The report should be in clear, concise and understandable language and upon receipt, the line supervisors should then make their complete analysis and take corrective steps to relieve any critical situations that might have developed.